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No.

Supreme Court, U.S.
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# In The Supreme Court of the United States

OCTOBER TERM, 1987

DUQUESNE LIGHT COMPANY
AND
PENNSYLVANIA POWER COMPANY
*Appellants,*

v.

DAVID M. BARASCH,
CONSUMER ADVOCATE, et al.
*Appellees.*

**On Appeal from the Supreme Court of Pennsylvania**

## JURISDICTIONAL STATEMENT

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January 12, 1988

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## QUESTIONS PRESENTED

1. Does the Pennsylvania Supreme Court's interpretation of Act 335 and other Pennsylvania ratemaking legislation effect a taking of property in violation of the Fifth and Fourteenth Amendments by precluding the state ratemaking agency from considering constitutionally pertinent factors in determining whether to permit recovery of prudently incurred investment in cancelled electric generating units?

2. Does the Pennsylvania Supreme Court's interpretation of Act 335 and other Pennsylvania ratemaking legislation to deny utility investors any recovery of or on prudently incurred investment in cancelled electric generating units effect a taking of property in violation of the Fifth and Fourteenth Amendments where the state ratemaking agency has concluded that the appropriate balance between investor and consumer interests requires the recovery of such investment?

## PARTIES BELOW

In addition to David M. Barasch, Consumer Advocate, the appellants below were Equitable Life Assurance Society, Joseph Horne Company, Kaufmann's and Gimbels. The Pennsylvania Public Utility Commission was the appellee below. Appellants Duquesne Light Company and Pennsylvania Power Company were intervenors below.

## STATEMENT OF CORPORATE RELATIONSHIPS

Appellant Pennsylvania Power Company is a wholly owned subsidiary of Ohio Edison Company.



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**On Appeal from the Supreme Court of Pennsylvania**

## JURISDICTIONAL STATEMENT

Duquesne Light Company ("Duquesne") and Pennsylvania Power Company ("Penn Power") appeal from the final judgment of the Supreme Court of Pennsylvania, dated October 15, 1987, holding that Act 335, as incorporated in 66 Pa.C.S. § 1315, is not unconstitutional as being violative of the Fifth and Fourteenth Amendments to the Constitution of the United States.

## OPINIONS BELOW

The opinion of the Supreme Court of Pennsylvania (App. A) is reported at 532 A.2d 325. The opinion of the Commonwealth Court of Pennsylvania (App. B) is reported at 90 Pa. Cmwlth. 98, 494 A.2d 58. The Opinion and Order of the Pennsylvania Public Utility Commission ("PUC") in Duquesne's case (App. C) is reported at 51 P.U.R.4th 198. The PUC's Opinion and Order Upon Reconsideration in Duquesne's case (App. D) is

reported at 52 P.U.C.4th 644. The PUC's Opinion and Order in Penn Power's case (App. E) is reported at 60 P.U.R.4th 593.

## JURISDICTION

The Supreme Court of Pennsylvania entered judgment on October 15, 1987. Duquesne Light Company and Pennsylvania Power Company filed a timely notice of appeal in the Supreme Court of Pennsylvania on January 7, 1988. This appeal is being docketed within 90 days of the date of the judgment below. This Court has appellate jurisdiction under 28 U.S.C. § 1257(2).

## CONSTITUTIONAL AND STATUTORY PROVISIONS

United States Constitution, Amendment V, clause 4:

> [N]or shall private property be taken for public use, without just compensation.

United States Constitution, Amendment XIV, clause 3:

> [N]or shall any State deprive any person of ... property, without due process of law....

Act 335, as incorporated into § 1315 of the Pennsylvania Public Utility Code, 66 Pa.C.S. § 1315, and Chapter 13 of the Pennsylvania Public Utility Code, 66 Pa.C.S. §§ 1301–1325, are reprinted in Appendix L. Other pertinent acts amending the Pennsylvania Public Utility Code are summarized in Table A (App. 1m-3m) and are reprinted in Appendix M.

## STATEMENT OF THE CASE

During the late 1960s, substantial annual increases in demand for electric power, and the massive New York City and Northeast blackouts, prompted nationwide concern that electric utilities soon would be faced with insufficient generating capacity. In Pennsylvania, the



PUC opened an investigation of a perceived failure on the part of Pennsylvania's jurisdictional electric utilities to begin construction of needed plant additions. *See Investigation of the Need for Additional Electric Generating and Transmission Facilities*, 46 Pa. P.U.C. 23 (1972).

This investigation led the PUC to conclude that "a desperate situation was developing" which could "within the near future ... result in possible blackouts and customer load curtailments." *Id.* at 24. In light of this conclusion, the PUC instructed Pennsylvania's electric utilities "that immediate preparations should be made to increase installed capacity until a reliable reserve of 20% above forecasted loads was reached." *Id. See* App. 13c. *See also, Pennsylvania Public Utility Comm'n v. Metropolitan Edison Co.*, 47 Pa. P.U.C. 56 (1973).[1]

In 1967, Duquesne and Penn Power, along with Ohio Edison Company, The Cleveland Electric Illuminating Company and The Toledo Edison Company, had formed the Central Area Power Coordination Group ("CAPCO"). One of CAPCO's principal objectives was to take advantage of the economies of scale through the joint construction and financing of electric generating facilities. In accordance with this objective, the CAPCO companies, in the early 1970s, authorized the construc-

[1]The following passage from the PUC's Opinion in the *Metropolitan Edison* case illustrates the pressures placed on the electric industry in the late 1960s and early 1970s to expand their generating facilities:

> "This Commission, and other regulatory bodies consider essential the continuing construction of electric generating capacity to meet the energy needs of the public. Respondent and other electric companies in Pennsylvania are continuing heavy expenditures to add additional generating facilities as rapidly as possible to meet adequately the public demand for service. *To protect the public interest*, this Commission has insisted that construction be accelerated and all feasible methods adopted to meet the present emergency." 47 Pa. P.U.C. at 59 (Emphasis added).

tion of seven large nuclear generating units, including Davis-Besse Unit Nos. 2 and 3 and Erie Unit Nos. 1 and 2, which are the four units at issue in this case (the "four CAPCO units"). Thereafter, each of the member CAPCO companies incurred substantial pre-construction expenses relating to the four CAPCO units.

In January of 1980, prior to the issuance by the Nuclear Regulatory Commission of construction permits for the four CAPCO units, CAPCO announced their cancellation. The intervening events which led to this decision are documented at length in Administrative Law Judge Joseph P. Matuschak's Report of Investigation at Dockets I-79070315 and I-79070317 (Pa. P.U.C. October 15, 1982) (App. H) (the "CAPCO Investigation").[2] In summary, Judge Matuschak found that the 1974 recession, the mild summers and winters of 1974 and 1975, and, most importantly, the Arab oil embargo had caused wholly unexpected and unforeseeable changes in the previously consistent pattern of annual growth in electric demand confronting Duquesne and Penn Power. When combined with the accident at Three Mile Island in 1979, these circumstances demanded a re-evaluation of CAPCO's construction program. Because these extraordinary events could not have been predicted, and indeed were directly contrary to the consensus demand for expansion of generating capacity that prevailed in the late 1960s and early 1970s, Judge

[2]The CAPCO Investigation resulted from the PUC's decision in July of 1979 to institute proceedings against Duquesne and Penn Power for the purpose of determining whether recently announced delays in a number of CAPCO sponsored nuclear generating stations, including the four CAPCO units, were justifiable. While that investigation was pending before Judge Matuschak, cancellation of the four CAPCO Units was announced. The CAPCO Investigation thereafter focused upon, *inter alia*, both the prudence of CAPCO's decision to begin construction of these units and the prudence of CAPCO's later decision to cancel them.



Matuschak concluded that CAPCO, and specifically Duquesne and Penn Power, could not be faulted for having embarked on the construction of the four CAPCO units, nor for their decision to cancel those units in 1980. To the contrary, he found that "the CAPCO decisions in regard to the Davis-Besse 2 and 3 and Erie 1 and 2 nuclear units, at every stage to their cancellation, were reasonable and prudent." (App. 19h).[3]

Judge Matuschak then recommended that Duquesne and Penn Power be permitted a recovery *of* their investments in the four CAPCO units over a period of ten years but not be allowed to earn any return *on* the amount of their investment remaining to be recovered during the rest of the period, thereby balancing the burden of this loss between the utilities' shareholders and ratepayers.[4] The PUC agreed and proceeded to allow Duquesne to begin to recover its investment in the four CAPCO units by way of a ten-year amortization in its next rate proceeding, which is the rate proceeding at is-

[3]The PUC by Opinion and Order entered January 13, 1983 adopted the Report of Investigation. (App. li). This order was never appealed. The PUC later explicated its reasoning in its Opinion and Order Upon Reconsideration in the Duquesne case. (App. 9d). In all proceedings below, the prudent nature of the costs at issue has been undisputed.

[4]Judge Matuschak's opinion and the papers in this case contain repeated references to a "return *of*" and a "return *on*" electric plant cancellation costs. The difference between these terms is best explained by example. An investor who provides another with funds, e.g., a financial institution which lends funds to a home buyer, expects repayment in two ways. First, the investor desires ultimately to retrieve his or her initial investment, e.g., by periodic amortization or principal payments equalling the amount originally invested. In utility parlance this is referred to as a "return *of*" or "recovery *of*" the investment, and usually is accomplished through "amortization" or "depreciation" charges. Second, the investor desires to receive compensation for the use of his or her funds by a periodic payment representing a percentage or other yield on the unrecovered balance of the investment. In utility parlance the compensation for use of invested funds is referred to as a "return *on*" the investment.

sue in this case. (App. 35c-37c) The PUC later authorized Penn Power to do the same. (App. 81e-82e).[5]

The PUC's decision in Duquesne's rate case allowing a recovery *of* Duquesne's investment in the four CAPCO units was entered on January 28, 1983. After the record had been closed and the issues briefed, but before the PUC's decision in that case, Act No. 1982-335, P.L. 1473 ("Act 335") (App. 6m-7m) was enacted on December 30, 1982, adding Section 1315 to the Pennsylvania Public Utility Code. *See* 66 Pa.C.S. § 1315. Act 335 was adopted in response to public concern that the PUC might depart from its past practice and allow over $500 million of the costs associated with Philadelphia Electric Company's Limerick nuclear generating station then under construction to be included in rate base prior to completion. (App. 6b-7b). Act 335 effectively prohibited the PUC from doing so and, in this respect, served to confirm the PUC's past practice under which such "construction work in progress" costs ("CWIP") were, except in certain circumstances not relevant here, not permitted to be included in rate base until the underlying project or facility had been placed in service. (App. 13c-13d).[6]

[5]As reflected in the record, Duquesne's claim for such expenses amounted to $34,697,389, before taxes. Penn Power's claim totalled $15,609,628 before taxes. An itemization of total CAPCO expenditures on the four CAPCO units, as submitted by Penn Power to the Federal Energy Regulatory Commission ("FERC") is contained in Appendix J (App. 19j-25j).

[6]A public utility can be compensated in either of two ways for the "time value" of its funds invested in major construction projects with respect to the period between expenditure and completion of the project.

First, the carrying charges on the construction costs may be capitalized as part of the project's historical cost through an "allowance for funds used during construction," (usually abbreviated either AFUDC or AFDC) equal to "the net cost for the period of construction of borrowed funds used for construction purposes and a reasonable rate on" equity used for such purposes. See FERC *Electric Plant Instruction* 3A(17). 18 C.F.R. Part

*(footnote continued on next page)*



On February 14, 1983, the Pennsylvania Office of Consumer Advocate ("Consumer Advocate") petitioned for reconsideration of the PUC's decision in Duquesne's rate case to allow recovery *of* Duquesne's investment in the four CAPCO units. The Consumer Advocate argued that Act 335 not only prohibited the inclusion of CWIP in rate base, but also prohibited any recovery *of* or *on* investment in cancelled generating units. On April 18, 1983, the PUC issued its Opinion and Order Upon Reconsideration, rejecting the Consumer Advocate's interpretation of Act 335 and affirming its prior ruling. (App. 10d-14d).

In Penn Power's case, the PUC adhered to its decision in Duquesne's case and, by Opinion and Order of April 11, 1984 (App. E), approved rate levels that included Penn Power's expense claim for a recovery, over a ten-year amortization period, *of* (but not a return *on*) its investment in the four CAPCO units.

In its Opinion and Orders of June 13, 1985, the Commonwealth Court affirmed the PUC's decisions in the Duquesne and Penn Power rate cases, holding that Act

101 (1987). This approach reduces the rates of ratepayers during the precompletion period, while correspondingly increasing relative rates during the postcompletion period.

Second, the value of the construction investment can be included in rate base, in the form of CWIP, prior to the completion of construction. Under this approach no AFUDC accrues after the investment is included in rate base. As a result, this approach increases rates during the precompletion period, while correspondingly decreasing relative rates during the postcompletion period. For a further discussion of CWIP and AFUDC, *see generally*, L. Schwartz, J. Flynn & H. First, *Free Enterprise and Economic Organization: Government Regulation* 465-492 (6th ed. 1985).

Consequently, an anti-CWIP statute merely *defers* the timing of the receipt by a utility of a return *of* and *on* its construction investment without adversely affecting the economic value of that investment. Because cancelled plants are never completed, application of an anti-CWIP statute to cancellation costs prevents a utility from *ever* receiving a return *of* or *on* its investment in such costs.

335 was intended only to exclude CWIP from *rate base* and had no applicability to an otherwise proper *expense* reflecting the recovery *of* prudently incurred investment in cancelled electric generating units. (App. 7b-8b).

In a concurring opinion, President Judge Crumlish supplemented the majority's reasoning by observing that the Consumer Advocate's reading of Act 335 would raise "serious constitutional problems" (App. 10b). As had been noted by the Commission below (App. 14d), and as had been argued by Penn Power and Duquesne, such a rule would pose a "real and not fanciful" confiscation issue.

Subsequent to the Commonwealth Court's decision, Act 62, adding § 520 to the Pennsylvania Public Utility Code, 66 Pa.C.S. § 520, was signed into law on October 10, 1985. (App. 19m-20m). The Pennsylvania legislature enacted § 520 in response to public pressure to define the PUC's authority to order the cancellation of electrical generating facilities under construction. In combination with the authority to cancel plants under construction, § 520 authorized the PUC to permit recovery *of* prudently-incurred investment in cancelled generating units by way of amortization without a return *on* the unamortized balance, precisely the result endorsed by the PUC and Commonwealth Court in this case. By its terms, however, § 520 applied only to cancellations effected after October 10, 1985.

The Pennsylvania Supreme Court reversed the Commonwealth Court in an opinion dated October 15, 1987. In that opinion, the Court recognized that the PUC had viewed "its decision to permit recovery through amortization" as

> a discharge of its duty to balance the interests of consumers and utility investors when determining what are "just and reasonable" rates.



532 A.2d at 331 (App. 11a). Nevertheless, the Court rejected the statutory construction analysis of the PUC and the Commonwealth Court, finding that the language of Act 335 was unambiguous on its face and applies to bar amortization or, for that matter, any recovery of utility cancellation costs. The Court then went on to discuss the various constitutional challenges raised by Duquesne and Penn Power.

In addressing the confiscation issue under the Fifth and Fourteenth Amendments to the United States Constitution, the Court cited a multitude of this Court's decisions predating *FPC v. Hope National Gas Co.*, 320 U.S. 591 (1944), but mentioned neither *Hope* nor this Court's more recent elaboration in *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968), nor recognized any obligation to balance consumer and investor interests in evaluating the end result of a utility rate order. 532 A.2d at 335-37 (App. 21a-26a). Instead, the Court merely held that the federal constitution's protection extends only to utility property that is "used and useful" and to operating expenses that represent "a cost of providing *present* utility service." 532 A.2d at 336 (App. 25a) (Emphasis in original).[7]

**THE QUESTIONS PRESENTED ARE SUBSTANTIAL**

This Court for many years has equated the "just and reasonable" standard found in most federal and state

[7]The Pennsylvania Supreme Court also rejected Appellants' equal protection arguments presented below, as well as Appellant Penn Power's constitutional challenge to the Court's interpretation of Act 335 to deny recovery for land held for future use. Appellants have acquiesced in these holdings for the purpose of this case and accordingly the questions presented do not encompass these issues. Appellants have not acquiesced in the Court's holding (App. 27a) that the Fifth and Fourteenth Amendments are not a bar to the retroactive application of Act 335 to investment made *and cancelled* prior to its enactment. However, this issue is moot here in light of the Court's reinterpretation of other Pennsylvania ratemaking legislation so as to make Act 335 merely cumulative. *See* note 9 *infra*.

ratemaking statutes[8] with the minimum constitutional requirement for avoiding the taking of utility investment. *See FPC v. Natural Gas Pipeline Co.*, 315 U.S. 575, 586 (1942). In *Hope*, this Court established a balancing test for determining whether rates are "just and reasonable," explaining that the "fixing of 'just and reasonable' rates involves a balancing of the investor and the consumer interests." *Hope*, 320 U.S. at 603. *Hope* also freed reviewing courts of the burden of having to scrutinize rate orders in great detail, as had been required under the "fair value" standard of *Smyth v. Ames*, 169 U.S. 466 (1898). The new approach established in *Hope* did not eliminate constitutional review of rate orders, but merely modified the reviewing court's role from analyzing the fair value of each item of utility property to determining whether the "end result" of the rate order represented a balance between investor and consumer interests.

In *Permian*, this Court elaborated on the role of the judiciary in reviewing the ratemaking process to insure that the statutorily and constitutionally-mandated balancing of interests has taken place. This Court stated:

> the [reviewing] court must determine whether the [rate] order may reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed, and yet provide appropriate protection to the relevant public interests, both existing and foreseeable. The court's responsibility is not to supplant the Commission's balance of these interests with one more nearly to its liking, but instead to assure itself that the Commission has given *reasoned consideration to each of the pertinent factors.*

[8] *See, e.g.*, Federal Power Act, 16 U.S.C. § 824d(a), and the Natural Gas Act, 15 U.S.C. §§ 717c(a), 717d(a).



> Judicial review of the Commission's orders will therefore function accurately and efficaciously only if the Commission indicates fully and carefully the methods by which, and the purposes for which, it has chosen to act, as well as its assessment of the consequences of its orders for the character and future development of the industry.

*Permian*, 390 U.S. at 792 (emphasis added).

In this case, the Pennsylvania Supreme Court completely ignored its obligations under *Hope* and *Permian*. The PUC below had given reasoned consideration to each of the pertinent factors as contemplated by *Permian*, and had issued a rate order that carefully balanced investor and consumer interests as required by *Hope*. Although it paid lip-service to the PUC's balancing effort, the Court, through its interpretation of Act 335 and other Pennsylvania ratemaking legislation,[9] obliterated the balance struck by the PUC. In doing so, the Court made no effort to determine whether under its construction of the applicable state law "each of the pertinent factors" identified in *Permian* could be considered, or whether the Duquesne and Penn Power rate orders, in the absence of the recovery of cancellation costs, reflected a proper balance of investor and consumer interests as required by *Hope*. Instead, the Court leaped backwards over *Hope* and *Permian* to resurrect isolated statements from *Smyth* and its progeny. The

[9] The Pennsylvania Supreme Court's wholly unnecessary reinterpretation of unspecified portions of the ratemaking provisions of the Pennsylvania Public Utility Code, so as to render Act 335 consistent with a general principle that no utility may *ever* recover its investment in cancelled facilities (thereby avoiding Appellants' equal protection arguments advanced below), renders the entire ratemaking chapter of the Code at issue in this case. Consequently, Appellants have printed all of Chapter 13 of the Code (relating to rates and ratemaking) in Appendix L. Throughout this Jurisdictional Statement, Appellants refer to the statutes at issue as "Act 335 and other Pennsylvania ratemaking legislation."

Court sought to justify the constitutionality of its statutory interpretation by holding that only "used and useful" property is entitled to constitutional protection.

The Pennsylvania Supreme Court's decision results in a rate order that is unfair to utility investors. The questions presented in this appeal address the procedural and substantive constitutional implications of this unfair end result. The answer to these questions has nationwide significance.

In the years following the Arab oil embargo, energy price inflation has produced a substantial decline in the rate of growth of consumer demand for electricity. At the same time, the cost of constructing the many large electric generating facilities planned during the decades of high growth in electricity demand have skyrocketed. When faced with requests for rate increases to compensate utility investors for their massive investment in completed plants, and their substantial investment in plants cancelled prudently in face of declining demand, state regulators, state courts and state legislatures have experienced significant public pressure to limit the growth of electric rates.[10] As a result, many such regulators, courts and legislatures have manipulated traditional ratemaking principles in an effort to minimize the

[10]The post-1973 Pennsylvania statutory changes (see Table A, App. 1m-4m) are graphic evidence of these pressures. *See, e.g.*, Act No. 1986-114 (§ 321), which requires an annual report by the Governor to the Pennsylvania Legislature. (App. 26m-27m). The report is required to contain a summary of all rate proceedings completed by the Pennsylvania Commission within the reporting period, the amount of the rate increase requested in each such proceeding, the amount of the request granted by the Commission in each such proceeding, and the percentage increase in rates requested and granted in each such proceeding as compared to the percentage increase requested and granted in the most recent similar proceeding for the affected utility prior to the reporting period. The statute does not similarly mandate reporting on the status of or adequacy in the allowed and achieved return *of* or *on* the utility's investment.



resulting rates. These result-oriented actions often produce state rate orders that test the limits of constitutional takings.

Unfortunately, rather than recognize the serious constitutional implications of their actions, state courts have increasingly ignored the principles this Court articulated in *Hope* and *Permian*. Although some state courts recognize that constitutional limitations still govern the extent to which a state may deny utility investors a recovery of prudently incurred costs,[11] other state courts have permitted[12] or denied[13] recovery *of* or *on*

[11]*See e.g., People's Organization v. Washington Utilities & Transp. Comm'n*, 711 P.2d 319 (Wash. 1986); *State ex rel. Union Elec. Co. v. Public Service Comm'n*, 687 S.W.2d 162 (Mo. 1985). When presented with essentially the same statute and facts as involved in this case, the Missouri Supreme Court in *Union Electric* recognized the serious constitutional infirmities in extending an anti-CWIP statute to cancellation costs, and, unlike the Pennsylvania Supreme Court in this case, adopted a limited statutory construction similar to that of the PUC and Commonwealth Court below.

[12]*See, e.g., Attorney General v. Department of Public Utilities*, 390 Mass. 208, 455 N.E.2d 414 (1983) (collecting cases); *Wisconsin Public Service Corp. v. Public Service Comm'n*, 109 Wisc.2d 256, 325 N.W.2d 867 (1982); *Central Maine Power Co. v. Public Utilities Comm'n*, 433 A.2d 331 (Me. 1981).

[13]This Court previously has been asked to review state rate orders from Ohio and Indiana that denied recovery of prudently incurred investment in cancelled plants. *See Northern Indiana Public Service Co. v. Citizen's Action Coalition of Indiana, Inc.*, 485 N.E.2d 610 (1985), *appeal dismissed and cert. denied*, 106 S.Ct. 2239 (1986) ("NIPSCO"); *Cleveland Elec. Illuminating Co. v. Public Utilities Comm'n*, 4 Ohio St. 3d 107, 447 N.E.2d 746, *appeal dismissed*, 464 U.S. 804 (1983) (dismissed for want of a substantial federal question) ("*CEI*"). *See also Office of Consumers' Counsel v. Public Utilities Comm'n*, 67 Ohio St. 2d 153, 423 N.E.2d 820 (1981), *appeal dismissed*, 455 U.S. 914 (1982) (dismissed for want of a properly presented federal question); *Cleveland Elec. Illuminating Co. v. Public Utilities Comm'n*, No. 82-165 (Ohio, July 7, 1982), *appeal dismissed*, 459 U.S. 1094 (1983) (dismissed for want of a properly presented federal question). Although *CEI* involved Ohio's treatment of the same four CAPCO units at issue in this case, the utility did not seek review on the issue of *Hope's* balancing test and *Permian's* standard of review. And, of course, *CEI* did not involve the statutory issues discussed *infra* specific to Pennsylvania. This Court "has repeatedly stated

*(Footnote continued on following page)*

such costs with little regard for the constitutional implications. The reluctance of state courts to engage in meaningful constitutional review of rate orders is likely the result of their substantial uncertainty over the meaning of *Hope* and *Permian*, combined with a perception that their decisions, regardless of the end result, are effectively insulated from federal review.[14] This is not surprising. Next term will mark the 50th anniversary of *Driscoll v. Edison Light and Power Co.*, 307 U.S. 104 (1939), the last state fixed service rate order reviewed by this Court. Indeed, as the hiatus in federal review has matured into a half century of desuetude, one state supreme court has actually been moved to declare that "[t]he federal constitution no longer provides any special protections for utility investors." *Dayton Power Co. v. Public Utilities Comm'n*, 4 Ohio St.3d 91, 447 N.E.2d 733 (1983).

The state courts are not alone in their confusion over the meaning of *Hope* and *Permian*. Even federal regulators and the federal judiciary appear to be in a quandary over how to interpret and apply *Hope's* balancing test and *Permian's* standard of review. Nowhere is this federal misunderstanding more evident than in the in-

*(Footnote continued from previous page)*
that although summary dispositions are decisions on the merits, the decisions extend only to 'the precise issues presented and necessarily decided by those actions.' " *Metromedia, Inc. v. City of San Diego*, 453 U.S. 490 (1981) (quoting *Mandel v. Bradley*, 432 U.S. 173 (1977)). Moreover, this Court has often given plenary consideration of the merits of a case, rather than rely on an earlier summary disposition. *See e.g., Bowers v. Hardwick*, 106 S.Ct. 2841, 2843, n. 4 (1986). *NIPSCO* did present the *Hope* balancing issue for this Court's review, but the *NIPSCO* appeal had to be dismissed because the utility had failed to preserve its constitutional issues below.

[14]The Johnson Act, 28 U.S.C. § 1342 (1984), prohibits the lower federal courts from reviewing state ratemaking decisions. Consequently, this Court is the only federal forum available for resolving constitutional infirmities in state rate orders.



credibly divergent interpretations advanced by the utility, the FERC, the FERC's own counsel, the majority opinion, the concurring opinion and the dissent in *Jersey Central Power & Light Co. v. FERC*, 810 F.2d 1168 (D.C. Cir. 1987) (en banc), itself a cancellation cost case.[15] The wide gulf separating these interpretations makes clear that age has heavily obscured the contemporary meaning of *Hope* and *Permian*, even in their original federal context. Therefore, there is a critical need for this Court's guidance to courts and regulators at all levels in understanding and applying *Hope* and *Permian* and in confirming their continuing viability. The present case presents this Court with the opportunity to provide such guidance.

[15]*Jersey Central* involved a utility's claim for rate base treatment of (i.e., return *on*) the unamortized portion of its cancellation costs. Consistently with its practice, *see e.g., NEPCO Municipal Rate Comm'n v. FERC*, 668 F.2d 1327 (D.C. Cir. 1981), *cert. denied*, 457 U.S. 1117 (1982), FERC had summarily permitted recovery through amortization *of* the cancellation costs, but no return *on* the unamortized balance. The utility, citing *Hope*, sought a return *on* the unamortized balance because its financial position otherwise would be impaired. The FERC initially took the position that a court reviewing its order had little, if any, role to perform. *See* 810 F.2d at 1175 (App. 15k). Before the en banc panel of the District of Columbia Circuit, FERC's counsel argued that a reviewing court could set aside a rate order only where the order would put the utility into bankruptcy. *Id.* (App. 15k). The majority read *Hope* to require a hearing where the utility alleges that the rate order would produce financial hardship. *Id.* at 1175-1182 (App. 14k-30k). The concurring opinion treated *Hope* as requiring that a balancing of investor and consumer interests be performed, in the first instance, by rate regulators and treated the ultimate object of the ratemaking process as seeking to reach a "just result," and thus concurred in remanding the case for a hearing. *Id.* at 1188-1194 (App. 43k-57k). The dissent suggested that the FERC's practice of permitting recovery *of* but denying a return *on* investment in cancelled plants constituted an appropriate balancing of interests such that no further hearing was required. *Id.* at 1194-1215 (App. 57k-107k). It is noteworthy that neither FERC nor the dissent (authored by Mikva, J.) ever suggested that a utility be denied recovery *of* its investment in cancelled plants. Indeed, it bears emphasizing that the dissenters recognized that FERC's practice (to which the PUC conformed below) represents an appropriate balancing of interests. *See* 810 F.2d at 1211-12 (App. 98k-99k).

In the absence of meaningful guidance, state regulators and legislatures have tested the boundaries of constitutional takings in a number of different ways. At the operative level of ratemaking, state regulators have exercised their considerable discretion by employing ratemaking principles that limit recovery of utility investment without regard to the balancing of interests required by *Hope* and *Permian*.[16] At the policy level of ratemaking, state legislatures, by way of statute, have attempted to limit a state regulator's discretion to consider certain utility costs or investments relevant to determining a proper balance between investor and consumer interests. Indeed, as reflected in the present case, Pennsylvania is a jurisdiction that has adopted this latter approach. Since the Arab oil embargo, Pennsylvania has effected more than 20 statutory modifications or amplifications to its basic "just and reasonable" rate-

[16]Just last term, this Court was presented with a constitutional challenge to a state commission's use of a new valuation method which denied a return *on* (but not recovery *of*) much of a utility's investment in a completed nuclear power plant without accounting for the balance of ratepayer and investor interests. *See Kansas Gas & Elec. Co. v. State Corp. Comm'n*, 232 Kan. 483, 720 P.2d 1063 (1986), *probable jurisdiction noted*, 107 S.Ct. 1281, *appeal dismissed*, 107 S.Ct. 2171 (1987); *Kansas City Power & Light Co. v. State Corp. Comm'n*, 232 Kan. 483, 720 P.2d 1063 (1986), *probable jurisdiction noted*, 107 S.Ct. 1281, *appeal dismissed*, 107 S.Ct. 3280. However, after this Court had noted probable jurisdiction, the *Kansas* cases were dismissed without a substantive decision on the *Hope* issue. In the *Kansas Gas & Elec.* case, this Court dismissed the *Hope* question as having been rendered moot, and dismissed the utility's equal protection challenge for want of a substantial federal question. *See* 107 S.Ct. 2171. The *Kansas City Power & Light* case was dismissed by agreement of the parties pursuant to Rule 53 of this Court's Rules. *See* 107 S.Ct. 3280. In the *Kansas* cases, the utilities were concerned with the depressed level of the authorized return *on* their investment, but they at least were entitled to a *complete* recovery *of* their investment through annual depreciation charges. Here Appellants have claimed *no* return *on* their investment, and have been denied *any* recovery *of* their investment. Therefore, this case provides an even more compelling opportunity to address the contemporary meaning of *Hope* and *Permian*.



making rules. *See* Table A (App. 1m-4m). These range from the conventional[17], through a series of acts tinkering with various details of the ratemaking process[18], to attempts to affect particular pending proceedings.[19]

This case involves an extreme example of such manipulation. It presents the question, not previously given plenary consideration by this Court, whether a state may prohibit *any* consideration of selected constitutionally pertinent facts in fixing utility rates. Because the Pennsylvania Supreme Court disregarded the guarantees of the Fifth and Fourteenth Amendments in construing the Pennsylvania statutes at issue, and because federal and state courts and agencies across the country

[17]E.g., Acts Nos. 1984-153 and 240, transferring Pennsylvania from a fair value to an original cost (prudent investment) ratemaking jurisdiction.

[18]E.g., mandating a shared benefit procedure to encourage use of coal (§ 514); permitting consideration of adequacy of service in fixing rate levels (§ 523); permitting use of future test years (§ 524); requiring consideration of savings from cogeneration (§ 527); permitting recovery of costs associated with conservation or load management programs (§ 1319); prohibiting consideration of certain advertising costs (§ 1316), membership fees in fraternal, social or sports clubs (§ 1316.1), certain personal costs associated with conferences or other events (§ 1321) and certain costs related to outages (§ 1322); and requiring certain amounts to be disallowed on account of excess capacity (§ 1323(a)). The text of these statutes appears in Appendix M (App. 5m-36m).

[19]E.g., refunds with respect to coal purchases in 1974 (Act No. 1976-226); exclusion of costs related to cancelled plants and exclusion of CWIP (Act No. 1982-335 (§ 1315) (the statute involved in the instant case), applicable to all cases pending before the PUC or the courts); status of initial cost estimates of large electric generating units (Act No. 1984-123 (§ 1308(f) ), retroactive to beginning of construction of pending units); recovery of prudent costs associated with cancelled electric generating units (Act No. 1985-62 (§ 520), applicable to units cancelled after October 10, 1985); expense reductions for 1986 as compared with 1985 (Act No. 1986-114 (§ 522) ); rejection of rates where quality of service is inadequate (Act No. 1986-114 (§ 526), applicable to all cases pending before the PUC or the courts); and exclusion of costs of new unit which is out of service at date rate case decided (Act No. 1986-114 (§ 1323(b) ), applicable to all cases pending before the PUC). The text of these statutes appears in Appendix M (App. 5m-36m).

are hopelessly divided over the Constitution's requirements in the area of public utility rate regulation, the questions presented here are substantial and warrant plenary review.

### I. A State Legislature May Not Preclude A Ratemaking Agency From Considering Factors Pertinent To The Balance Between Investor And Consumer Interests

Historically, state ratemaking commissions were formed to relieve legislatures of the cumbersome task of setting rates by legislation. In delegating legislative tasks to ratemaking agencies, the separation of powers principle has long required that the legislature provide minimum standards to define the duties and powers of the delegatee. *See e.g. A.L.A. Schechter Poultry Corp. v. United States*, 295 U.S. 495 (1935). On the other hand, where the ratemaking decisions of the agency can have constitutional implications for private parties, the agency must be invested with discretion sufficient to conform its decisions to constitutional mandates. The lesson of *Hope* and *Permian* is that rate orders must reflect a balance of investor and consumer interests in order to avoid a taking of property without just compensation. Consequently, a necessary corollary of the *Hope* balancing test is that a state ratemaking agency must possess under state law sufficient discretion within the boundaries of its ratemaking authority to balance investor and consumer interests and thereby produce a constitutional end result. In short, *Hope* and *Permian* require that the one who sets rates must balance.[20]

*Permian* makes it clear that *Hope's* "end result" test does not eliminate entirely the need for a reviewing

[20]In concept, this principle is not unlike the familiar administrative law principle developed from notions of due process that "the one who decides must hear." *See Morgan v. United States*, 298 U.S. 468, 481 (1936).



court to scrutinize the ratemaking process. Although states are free to select among a wide variety of regulatory methods, the method selected must be coherent. *Permian* requires that the ratemaking agency articulate "fully and carefully the methods by which, and the purposes for which, it has chosen to act," and assess the consequences of its action on the balance between investor and consumer interests. 390 U.S. at 792. As the United States Court of Appeals for the District of Columbia Circuit recognized shortly after *Hope*, courts may reject ratemaking formulas that produce an arbitrary end result. *See Mississippi River Fuel Corp. v. FPC*, 163 F.2d 433, 439 (D.C. Cir. 1947). Indeed, this Court has stated that "it is much easier to reject formulas as being misleading than to find one apparently adequate." *Colorado Interstate Co. v. FPC*, 324 U.S. 581, 590 (1945) (quoting *Groesbeck v. Duluth, S.S. & A. RY.* 250 U.S. 607, 614 (1919)).

States are also free to exclude all consideration of factors that are not pertinent to the coherent method selected. *Hope's* approval of the exclusion of fair value rate base evidence in the context of a prudent investment system is itself the quintessential example of the application of this rule. In recent years, however, Pennsylvania has strayed from a coherent "original cost" methodology by passing legislation designed to remove entirely from the Commission's consideration certain types of utility investments. The Commission is thus deprived of hearing all of the factors pertinent to a fair balancing of interests. Moreover, this legislation is sometimes enacted without regard for how it affects the balance between investor and consumer interests in the cases before the PUC, or worse, with an eye to predetermining the outcome of pending cases. In short, the

legislature has attempted through a hodge-podge of special ratemaking rules to place its heavy finger selectively on the balance between investor and consumer interests without itself undertaking the full analysis of pertinent factors required by *Hope* and *Permian*.

The lack of coherence inherent in the present Pennsylvania ratemaking process is apparent from the interplay of Act 335 and the subsequently enacted § 520 of the Pennsylvania Public Utility Code. *Compare* 66 Pa.C.S. § 1315 *with* 66 Pa.C.S. § 520. Section 520 permits amortized recovery *of* (but not a return *on*) the prudently incurred costs of cancelled electrical generating plants. But § 520 applies by its terms only to cancellations effected after October 10, 1985, a date conveniently subsequent to the well-known January 22, 1980 cancellation date of the four CAPCO units. Consequently, the effect of the Pennsylvania Supreme Court's interpretation of Act 335 and related state law is to render the costs at issue in this case the *only* investment in cancelled electric generating stations that is barred by Act 335.

The striking feature of the Pennsylvania Supreme Court's opinion is its total failure to recognize any duty to seek to mold this disparate mass of state legislation into a coherent process ensuring that the end result of ratemaking in Pennsylvania will be fair to both investors and consumers. Instead, the Court endorsed the manipulative Pennsylvania legislative process, without recognizing a duty to balance. At minimum, due process requires that the PUC hear and consider the factors pertinent to a fair balancing between investor and consumer interests. As interpreted by the Pennsylvania Supreme Court, Act 335 and other Pennsylvania ratemaking legislation require the PUC to ignore entirely



the factors pertinent to the balance of interests with respect to a utility's prudent investment in cancelled power plants. These statutes, therefore, are unconstitutional on their face.

## II. The Balancing of Consumer and Investor Interests In This Case Requires Recovery of Prudently Incurred Investment in Cancelled Electric Generating Units

The Pennsylvania Supreme Court's failure to discharge its responsibility under *Hope* and *Permian* to examine the balance of investor and consumer interests results in a taking of the utility shareholders' investment without compensation. The appropriate balance of interests in this case requires at minimum that the shareholders of Duquesne and Penn Power recover their costs prudently invested in the four CAPCO units. A complete denial of any recovery produces rates that are not "just and reasonable," and, therefore, are unconstitutional.

The appropriate balance of interests in this case is reflected in the PUC order below. The PUC found that the shareholders' investment in preconstruction costs of the four CAPCO units was prudently incurred. Indeed, such investments were undertaken at the strong urging of the PUC because of the desperate need for expansion of electric generating capacity, and were consistent with the utilities' statutory duty to provide electrical service to consumers. See 66 Pa.C.S. § 1501. Thus, *consumer* interests supported, if not mandated, incurring the costs at issue.

Simple fairness dictates that the shareholders, having been requested and required to make substantial investments in generating facilities for the public interest,

must recover at minimum the funds they have prudently invested.[21] The PUC recognized this principle, and, in the belief that Act 335 did not apply, permitted the shareholders to recover the amounts they had invested, without recovering interest or any other return on their investment. Under this approach the shareholders do not profit from their investment, but also are not forced to bear the risk of the entire loss.[22]

The PUC was not alone in striking this balance. Indeed, this balance is consistent with FERC practice, *see Jersey Central*, 810 F.2d at 1172[23]; *NEPCO*, 668 F.2d at 1332-35, and FERC specifically approved recovery, through amortization, *of* the costs at issue here. (App. 1j-18j).

[21]It should be noted that, because of its arbitrary nature, the Pennsylvania Supreme Court's "heads the consumer wins, tails utility investors lose" interpretive approach and its acceptance of the incoherent interaction between § 520 and § 1315 (*see* p. 20 *supra*) do not even satisfy the existing standards for testing state economic regulation generally under the Fourteenth Amendment. *See generally Nebbia v. New York*, 291 U.S. 502, 525 (1934) and its progeny (requiring that economic regulation not be arbitrary or irrational).

[22]Even this result would not produce a complete economic retrieval of the shareholders' investment, because the denial of a return *on* the unamortized balances during the ten-year amortization period would take from the utility investors the time value of their invested funds. The effect of the "balance" struck by the Commission is to require the utility investors to provide consumers with what amounts to an interest-free loan. The economic effect of lengthening the amortization period can be dramatic. During the CAPCO investigation, the Administrative Law Judge recognized that Appellant Duquesne (App. 19h-20h):

> has paid its costs in connection with the cancelled plants for the past eight years, and will continue to do so over the next ten years. The investors will pick up more than 50% of the associated costs even if the Company's claim [for recovery *of* such costs] is paid in full.

[23]In *Jersey Central*, even the dissenters recognized the necessity of providing a recovery to utility shareholders:

> Under price regulations, which affords the utility a "natural monopoly" on service, some of the risk at either end of the spectrum is shift-

*(footnote continued on next page)*



Recovery *of* their investment thus is necessary "to compensate investors for the risks they have assumed." *Permian Basin*, 390 U.S. at 792. Indeed, the concept of balancing public and private interests appears throughout this court's constitutional takings analysis. In non-utility takings cases, this Court often has balanced the public interest in the property at issue with "reasonable, investment-backed expectations." *Kaiser Aetna v. United States*, 444 U.S. 164, 175 (1979).[24] In such cases, moreover, this Court has found confiscatory takings where the economic value of the property at issue was substantially below the absolute and proportional value of Duquesne's and Penn Power's investment in the cancelled plants at issue here.[25]

> ed onto the ratepayer. The transfer, however, is not so dramatic as to relieve the stockholder of the entire risk of loss.
>
> Application of this principle is readily apparent in the Commission's current treatment of electric utility plants, investments prudent when made but sometimes frustrated in fruition. If the investment is successful, the customer benefits from controlled rates for the service provided. But the ratepayer also shares the costs if the investment fails; he must pay for the expenditure made on an unproductive facility from which he obtains no service. From the investor's viewpoint, price regulation cabins both his upside and downside risk. He cannot collect the windfall benefits if the project is a boon; he does not bear all costs if the project is a bust. Electric utility stockholders do not lose equity in the non-serviceable facility, as they might in the marketplace. They simply do not procure a return on the investment.

810 F.2d at 1211-12 (Mikva, J., dissenting) (App. 98K-99K).

[24]*See e.g., Ruckleshaus v. Monsanto Co.*, 467 U.S. 986 (1984) (Federal regulation requiring disclosure of data effected a taking of pesticide company's investment-backed expectation of confidentiality in certain pesticide secrets); *Kaiser*, 444 U.S. at 179-80 (government imposition of navigational servitude effected a taking of petitioners' investment-backed expectation of their right to exclude which was based on their reasonable reliance on government's consent to connect private pond to navigable waters). Indeed, the landowner's reliance on governmental consent to the navigational channel at issue in *Kaiser* is comparable to the reliance of Duquesne and Penn Power on PUC mandates in undertaking to increase their generating capacity herein.

[25]*See e.g., Nollan v. California Coastal Comm'n*, 107 S.Ct. 3141 (1987) (conditioning landowners' rebuilding permit on granting of public easement

*(Footnote continued on following page)*

Prior to the enactment of Act 335, there was no suggestion in Pennsylvania that recovery of cancellation costs through amortization would produce exploitive rates. Moreover, federal courts have long recognized that utilities are entitled to recover amounts invested in prudently incurred expenses, including engineering expenses similar to those involved in this case. *See Mississippi River Fuel*, 163 F.2d at 438 (referring to engineering costs). The court in *Mississippi River Fuel* recognized that it was confiscatory for a ratemaking agency to deny recovery of prudently incurred expenses.[26] This is particularly so where historic federal and state treatment of prudently incurred expenses induces the legitimate investment-backed expectation that such expenses are recoverable.[27] When such expenses are denied, particularly where, as here, the record does not contain substantial countervailing consumer interests, the balance between investor and consumer interests is de-

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along narrow strip of beach at periphery of property constituted a taking); *see also Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419 (1982) (cable installation on appellant's building constituted a taking). Although *Loretto* involved a per se rule for "permanent physical invasion" of property, it is noteworthy that the actual space occupied may have been only slightly in excess of one and one-half cubic feet. In this case, the effect of the judgment below is to permanently deprive Appellants of the substantial funds expended on the four CAPCO units.

[26]As the District of Columbia Circuit recognized in *Mississippi Fuel*:

> Expenses (using that term in its broad sense to include not only operating expenses but depreciation and taxes) are facts. They are to be ascertained, not created, by the regulatory authorities. If properly incurred, they must be allowed as part of the composition of the rates. Otherwise, the so-called allowance of a return upon the investment, being an amount over and above expenses, would be a farce.

163 F.2d at 437.

[27]As late as 1982, the "overwhelming weight of authority" supported recovery *of* prudently incurred investment in cancelled plants. (App. 11h).



stroyed and the resulting rates become unconstitutionally confiscatory.

*Hope* and *Permian* are grounded in the theories of utility ratemaking contained in J. Bonbright, *Valuation of Property* (1937). Bonbright was at the forefront of developing the notion that a ratemaking agency need not employ any particular methodology, as long as the method employed is applied consistently. Bonbright was also aware that principles of "fair play" require that when changes are made to ratemaking methodologies the costs borne and rewards received by investors and consumers be related to their expectations and the risks they have assumed. *See* 2 J. Bonbright, *Valuation of Property* 1155 and n.113 (1937).

The Pennsylvania Supreme Court's decision in this case does violence to the reasonable expectations of utility investors and saddles them with risks that they did not voluntarily assume, without articulating a countervailing consumer interest. Denial of any recovery *of* the costs prudently invested in the four CAPCO units effects an unconstitutional taking of the investors' property.

## CONCLUSION

The Court should note probable jurisdiction.

Respectfully submitted,

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